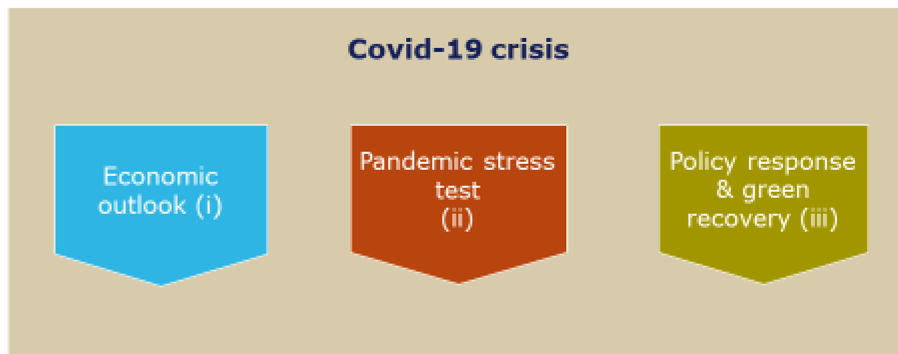
CFA webinar

Covid-19: the big reset?

4 February 2021: 15:30 – 17:30

Powerpoint Presentation

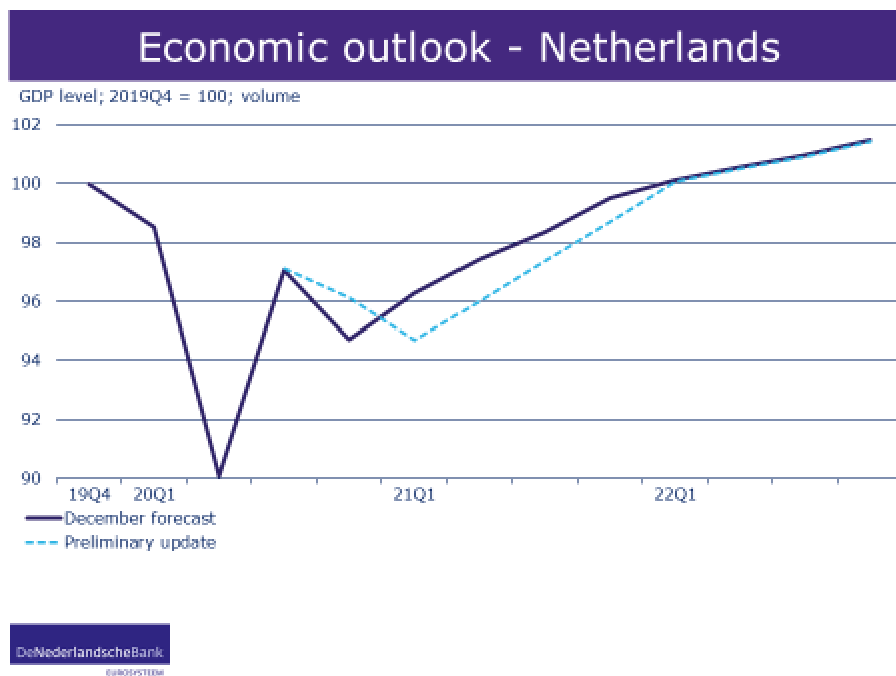
Slide 1: Intro



Slide 2: Outline

Presentation consists of three parts:

1. The economic outlook for the Netherlands, where I will also zoom in on the impact of the current lockdown for different business sectors compared to the first lockdown in spring last year.
2. The results of our pandemic stress test, where we assessed the impact of two severe macroeconomic scenarios on the capital position of Dutch banks and its implications for the supply of credit.
3. The policy response to soften the economic impact of the pandemic and how we can speed up the recovery by stimulating green investments.



Slide 3: Economic outlook (GDP) - Netherlands

• The Dutch economy suffered severe damage in the first two quarters of 2020, with GDP falling almost 10% compared to the fourth quarter of 2019. Subsequently, GDP rebounded strongly in the third quarter (7.8% q-o-q) when a significant part of the containment measures was relaxed, but driven by the second wave of infections and the reintroduction of containment measures, GDP is projected to decline again in the fourth quarter.

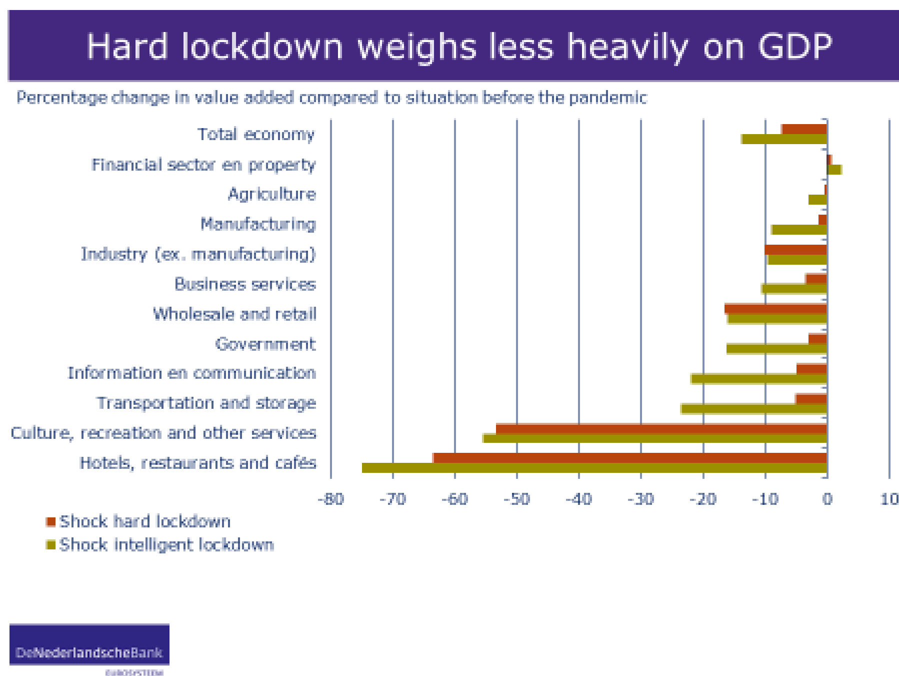
• This shows that the economy can recover rapidly once the pandemic is under control. Against this background, it is important that the number of infections is contained and that the crisis does not last too long.

• According to our December forecast, GDP has contracted by 4.3% in 2020. Although this figure is of historic proportions, it is less severe than the contraction of 6.4% projected in our June forecast. (The latest incoming data for 2020Q4 is better than expected and point at contraction of 3.9% in 2020).

• In our December forecast, GDP will gradually recover with 2.9% in both 2021 and 2022. This is based on the (outdated) assumption that the containment measures

of the so-called "partial lockdown" will be gradually phased out in 2021 up to the end of 2021, when the medical solution is successfully implemented.

- Contrary to the assumption of the December forecast, containment measures have actually been tightened since mid-December – in response to the revival of the second wave of infections. As a result, the short term economic outlook has deteriorated. This mainly will be at the expense of GDP growth in 2021. How much growth will be lost depends strongly on the development of the pandemic.
- A preliminary analysis suggests that, if the hard lockdown remains into effect until the beginning of March, GDP growth might be limited to 1.3% in 2021. For next year, this can lead to an acceleration of GDP growth to 4.2%, if we assume that the containment measures are no longer necessary after this year due to vaccinations.
- In sum, while the blow to the economy has been less severe than previously feared, the recovery in the short term is hampered by the revival of the second wave of infections.
- (Against the drawback of the "hard lockdown", there is also a windfall. The UK has left the EU with a deal, while our December forecast assumed a no-deal Brexit. This could lead to an upward effect on GDP growth of about half a percentage point in 2021. This has not been taken into account in the preliminary analysis of the impact of the "hard lockdown" on GDP.)

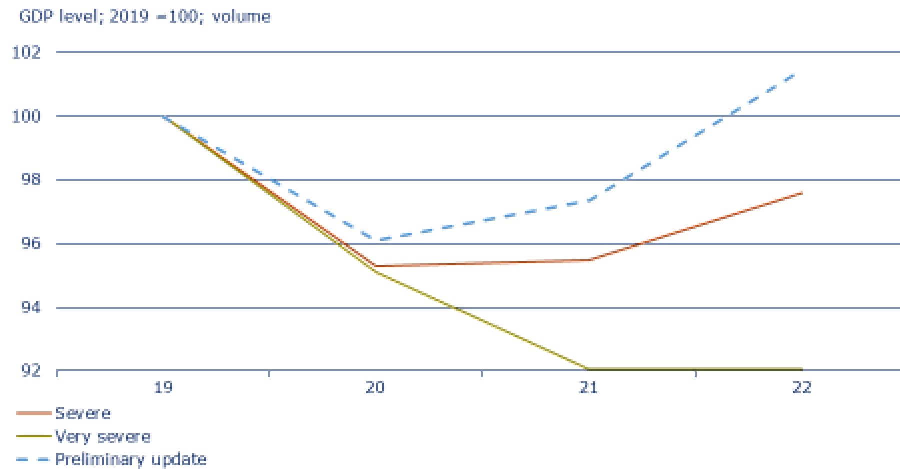


Slide 4: Hard lockdown weighs less heavily on GDP

• Domestic services, like the hospitality and culture sector, are most affected by the pandemic and the containment measures. The slide shows the estimated **marginal impact** of the "intelligent" and "hard" lockdown on the value added of different business sectors compared to the situation from before the pandemic. [fyi: *marginal*, as the shock displayed doesn't contain a time dimension. The *total* impact of the lockdown is approximated by the product of the marginal impact and the duration of the lockdown.]

• Compared to the "intelligent lockdown" from spring last year, we find that the marginal damage of the (current) "hard lockdown" is lower for almost all sectors. This partly reflects learning effects, enabling the economy to adapt faster. For instance, value added of the hospitality sector, such as bars and restaurants, declined less sharply this time, even though bars and restaurants were closed in both cases. This is probably because bars and restaurants switched earlier to alternative sales channels, such as delivery and take-away.

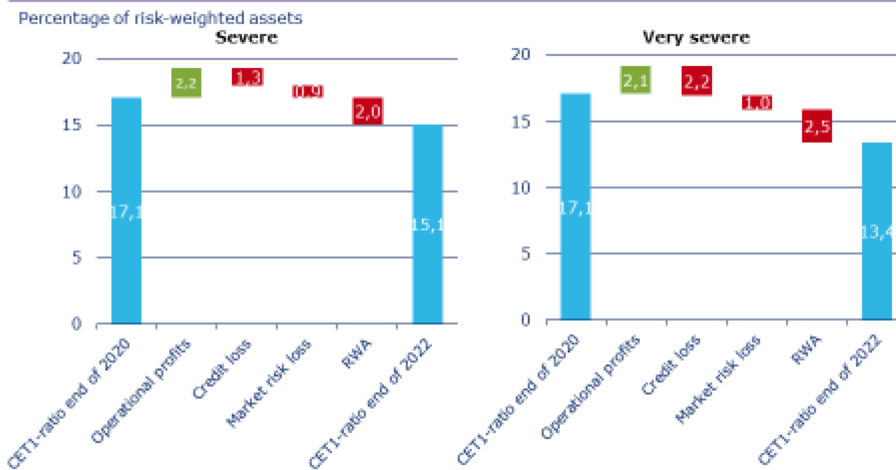
- Moreover, the shock currently being experienced by the export sectors, such as manufacturing and transportation, is expected to be less severe. This largely owes to the fact that the impact on world trade is less severe this time, as other parts of the world are less affected by a second wave.



Slide 5: Pandemic stress test: two scenarios

- Dutch banks have weathered the crisis relatively well so far, partly as a result of capital buffers built up in the years before the pandemic. The government and supervisory measures taken in the past year have also made a significant contribution.
- However, as the economic picture remains highly uncertain, we have updated our pandemic stress test from last June to assess the implications of a **severe** and a **very severe** macroeconomic scenario for Dutch banks.
- The severe scenario assumes that the medical solution will be implemented after the summer of 2022 and that containment measures will remain in effect until then. As a result, GDP will grow at a rate of 0.2% in 2021 and 2.2% in 2022.
- Compared to the severe scenario, the second stress scenario assumes an extremely slow and difficult vaccination process, with a fiercer resurgence of the virus in 2021 and substantial containment measures having to remain in place until the end of 2022. This scenario also assumes that the virus will remain out of

control not only in the Netherlands but also in the rest of the world, causing continued disruption to international trade. This would place considerable strains on the Dutch economy in 2021, with bankruptcies rising, confidence remaining low and risk premiums reaching high levels. As a result, GDP will contract again in 2021, without showing any recovery in 2022.



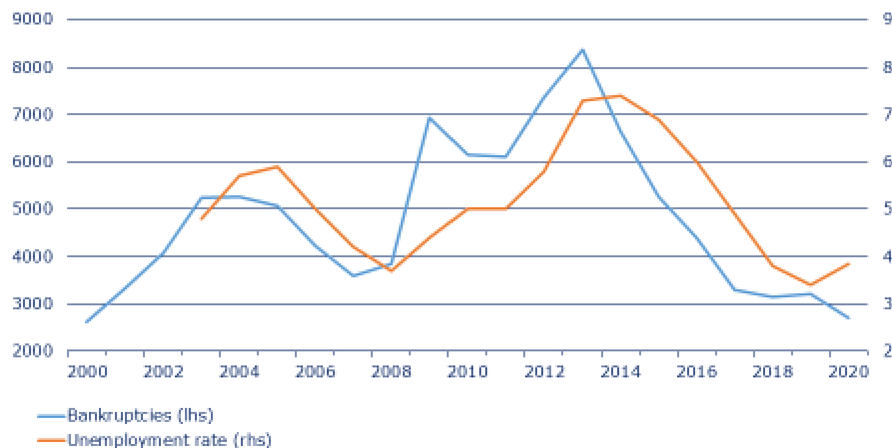
Slide 6: Deterioration of banks' capital position is manageable

• In the **severe** scenario, the average capital ratio of Dutch banks will fall by about 2 percentage points, from 17% to 15%. In the **very severe** scenario, capital ratios fall by an average of almost 4 percentage points, to 13%.

• In both cases, this would amount to a significant deterioration of Dutch banks' capital position. However, because of their relatively strong buffers, banks should be able to absorb this impact without having excessive repercussions in terms of lending to households and businesses. Moreover, the average capital ratio would remain comfortably above the regulatory capital requirements.

• The estimated impact on capital positions is now smaller compared to the our pandemic stress test from June last year. This difference can be explained by the upward adjustments to the economic outlook since June. Nevertheless, the impact on bank balance sheets can still be significant. That is particularly true if the government support measures are scaled back. It is therefore important that banks stay alert to the build-up of credit risks. In the period ahead DNB will continue to monitor closely the impact of economic developments on the financial sector.

Effective policy response limits damage



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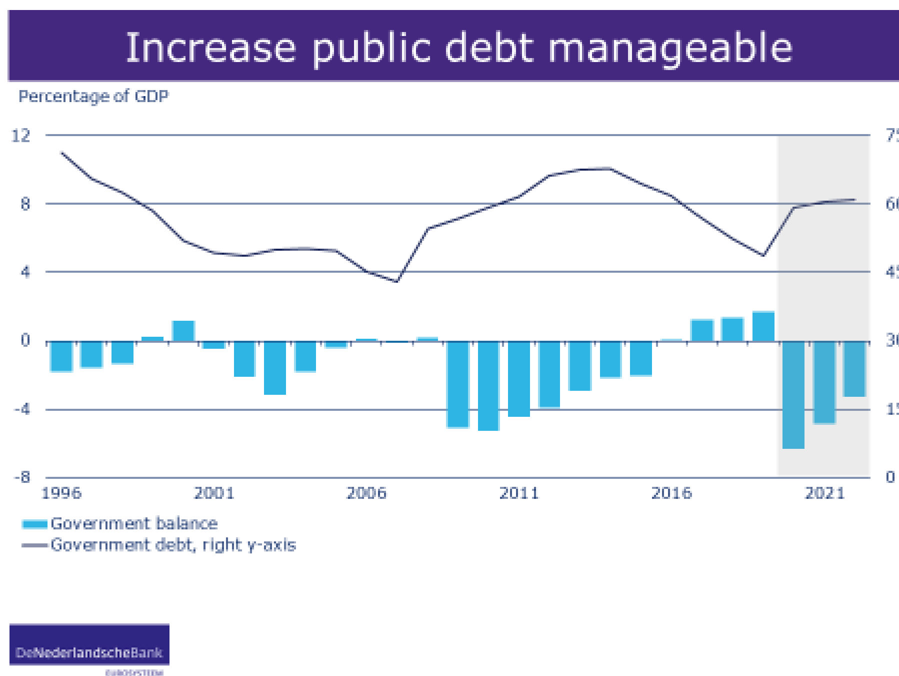
Slide 7: Effective policy response limits damage

• A comprehensive response by governments, central banks and prudential authorities managed to soften the blow and contain risks for the financial sector. With a global pandemic, there is a natural role for governments to act as businesses and households cannot protect themselves against such risks.

• In the Netherlands, government support measures in 2020 and 2021 together account for over 7% of GDP. [The largest measure is a wage subsidy for employers, followed by a compensation for fixed costs and an income subsidy for the self-employed.] On top of that, business have been able to defer their tax payments and apply for bank credit under state guarantees.

• These measures help prevent long-term economic damage caused by bankruptcies and job loss, and have been effective so far. Unemployment increased quite strongly at the start of the pandemic, but has since recovered and the overall increase is relatively muted. Bankruptcies reached a 20-year low in 2020.

- Government support should last no longer than necessary: apart from the budgetary costs, too lengthy support may also hamper economic dynamism and reallocation of production factors.
- However, the second lockdown and the roll-out of the vaccine imply an increased need in the short run as well as a perspective of bridging the gap. Support measures should therefore be continued until lockdown measures can definitively be lifted.

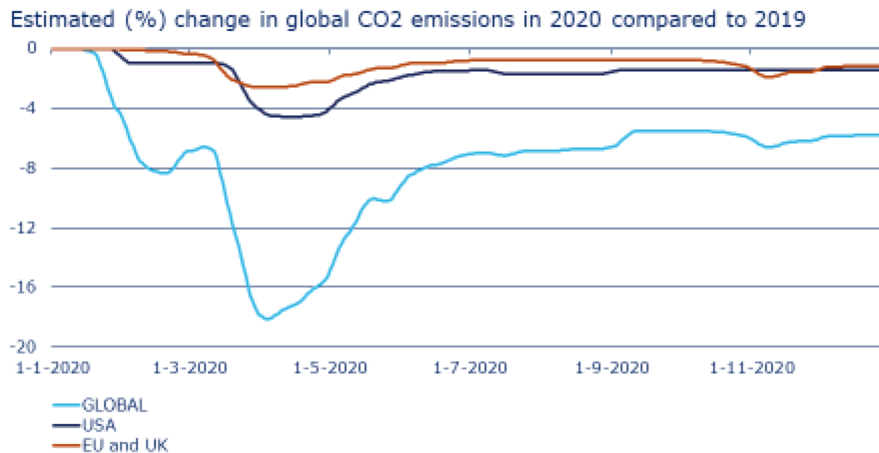


Slide 8: Increase public debt manageable

- The impact on public finances has been substantial. This emphasizes the benefits of building buffers in good times. In 2019, public debt had decreased to just below 50% of GDP, and the budget balance was in surplus.
- As a result of both support measures and automatic stabilisers in the budget, the budget balance in 2020 deteriorated to a deficit of over 6% of GDP. This is among the highest deficits since the Second World War. This year and next year the deficit is expected to remain above the 3% deficit criterion according to our December forecast.
- This leads to an increase in public debt of public debt from below 50% in 2019 to just over 60% of GDP this year, with the extended lockdown and additional support measures since December likely leading to a further upwards effect.
- While the increase in debt is sizeable, sustainability is not at risk. Compared to other euro area countries it remains relatively low, and Dutch government debt is expected to remain a safe investment.

- After the winding down of support measures, fiscal policy should therefore remain supportive. While we see no scope for a structural increase in fiscal spending, automatic stabilisers should be allowed to fully function to allow the recovery to take hold.

Green investments can speed up recovery



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Slide 9: Stimulate green investments to speed up economic recovery

• The recovery of the economy can be speeded up by increasing green investments that are already deemed necessary for the transition to a carbon neutral economy. Although the Covid-19 crisis depresses global carbon emissions, this is a temporary decrease (see graph) where a structural reduction in emissions is needed to meet the Paris climate targets. It is therefore essential that we seize the opportunity and aim for a green recovery from this crisis.

• Private investments by companies and households can be made more attractive via higher subsidies and fiscal incentives. Public sustainable investments can also be increased (for example public transport, energy infrastructure and nature restoration).

• We welcome the recent EU agreement on a higher emission reduction target of 55% in 2030. An ambitious EU green deal can give an important boost to green investments. Better carbon pricing is necessary for many sectors, which should be done at the EU level. DNB supports the EC proposals to tighten the reduction targets of the EU ETS and to widen the scope of the ETS to include new sectors

(transport, buildings). Implementation of a carbon border adjustment mechanism (CBAM) could potentially help prevent carbon leakage and keep EU companies competitive, but should be set up in a way consistent with WTO rules. Finally, EU agricultural subsidies should be made more dependent on stringent European sustainability conditions.

Key messages

1. Substantial economic impact, but less severe than feared
2. Short term outlook deteriorated due to hard lockdown
3. Pandemic stress test shows significant but manageable impact on capital position of Dutch banks
4. Support measures remain important in the short term
5. Green investments can speed up recovery

Slide 10: Key messages